2) Every carrier's universal service obligation would be computed annually based upon a non-discriminatory method such as, but not limited to, a percentage of telecommunications service revenues. As discussed below, each carrier could discharge its obligation by making a cash payment to the Fund, by providing subsidized services to end users, or a combination of both.

3) Carriers that provide basic exchange service (or other services that the Commission chooses to subsidize) would grant credits to eligible end users, similar to existing subsidized Lifeline rates, and these credits would be applied against the carriers' universal service obligation.

4) Those carriers who do not provide services eligible for credits, or who provide credits in less than the amount of their assessed obligation, would make a cash payment to the Fund administrator. The administrator would compensate those carriers who granted credits in excess of the amount of their obligation. Under this system, carriers providing local exchange service would continue to be the conduits for subsidy payments, but the cost of these payments would be made explicit and would be shared fairly by all carriers.

MFS understands that Professor Eli Noam of Columbia University, a former member of the New York Public Service Commission, has drafted a proposal for funding of universal service that meets many of the criteria discussed above. *See Communications Daily*, Oct. 12, 1993, p. 7. Although Professor Noam's "NetTrans Account" proposal, to the best of MFS' knowledge, has not yet been released in final form, MFS has reviewed a discussion draft of the plan and believes that it is generally compatible with the goals discussed in this section. (Professor Noam's proposal relates only to the method of assigning financial responsibility for universal service contributions, and does not address how those contributions should be distributed.) MFS hopes that this Petition can provide a vehicle for full Commission consideration of Professor Noam's proposal and of any other funding suggestions that may be advanced.

Conclusion

As discussed above, the preservation and advancement of universal service is one of the most significant policy issues facing the Commission as it continues to guide the telecommunications industry in the transition to full competition. In order to provide the necessary national leadership on this issue, and to eliminate any lingering uncertainty regarding the feasibility of promoting universal service within a competitive market, MFS urges the Commission to issue a Notice of Inquiry as outlined above, and to highlight the importance of this issue by conducting an *en banc* hearing at the earliest opportunity.

Respectfully submitted,

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LOCAL TELEPHONE COMPETITION AND THE "$20 BILLION SUBSIDY":

WHAT IT REALLY MEANS AND WHAT TO DO ABOUT IT

Local telephone companies have long claimed that the introduction of competition into their protected monopoly markets would endanger "subsidies" that keep basic telephone service affordable for all Americans. Some studies sponsored by the telephone industry estimate the "subsidy" at $20 billion per year.

Although this figure strains credibility and is not supported by the limited evidence, rather than argue about the existence or amount of subsidies, MFS Communications Company[1] believes that policymakers should concentrate on the constructive task of how to assure that affordable basic service remains available in a competitive market. This White Paper outlines a program to assure that basic service remains universally available at affordable rates, and that the cost of this program is borne equitably and in a competitively-neutral manner by *all* participants in the telecommunications market.

How is Telephone Service "Subsidized" Today?

Unlike some other industries, most telephone companies do not receive any direct subsidy from the U.S. Treasury. Rather, according to the local exchange companies ("LECs"), a variety of explicit and implicit subsidies are inherently incorporated into the rates paid by telephone users and subsequently collected and reallocated by the LECs themselves. Total LEC revenues cover the costs of profitable services, contribute to LEC overhead (regardless of their level of efficiency) and shareholder return, and reportedly also cover the costs of certain unprofitable or subsidized services.

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[1] MFS Communications Company, Inc. (MFS) is the largest provider of local competitive access telecommunications services in the United States. As an integrated telecommunications company, MFS provides a wide range of high quality voice, data and other enhanced services and systems designed to meet the requirements of communications-intensive business and government end users. Through subsidiaries, MFS owns and operates local fiber optic communications networks in 14 major metropolitan business centers throughout the United States. As of June 30, 1993, the company's fiber optic networks consisted of 1,030 route miles and 50,049 fiber miles.

First, three explicit subsidy programs are administered by the National Exchange Carrier Association (NECA) under FCC rules.[2] Two of these programs, the Universal Service Fund and the Lifeline Connection Fund, are funded by assessments on long-distance carriers. The Universal Service Fund provides direct subsidy payments to "high-cost" local exchange companies under a complex formula adopted by the FCC. The Lifeline Connection Fund compensates telephone companies for some of the revenue lost when they reduce or waive one-time connection charges for eligible low-income consumers. According to the FCC, these two programs collect and distribute about $800 million per year. The third program is the Common Line Pool, under which NECA receives "support" payments from large telephone companies and uses the funds to subsidize the line costs of the smaller companies that participate in the pool. The LECs that pay into the pool recover these amounts through their charges to long-distance carriers for network access. The amount of subsidy contained in this system is harder to measure because some of the pool represents companies' actual revenues and costs rather than a subsidy.[3] Many states have their own independent subsidy programs, as well.

Second, and more significantly, the telephone companies argue that basic local telephone service is implicitly subsidized through higher prices for long-distance services (including both the short-haul toll services offered by the telephone companies themselves, and their charges to long-distance carriers for network access). This artificial pricing, they claim, keeps basic local rates lower for everyone. Therefore, customers who generate a lot of switched long-distance calls "subsidize" those who make few or none. (The FCC has concluded that special access services used by large business customers with private lines are not priced above cost and therefore do not contribute any subsidy.) Furthermore, the local telephone companies argue that the introduction of local competition would cause them to lose revenue as long-distance calls are originated and terminated over competing networks, forcing them to raise basic local rates for their remaining subscribers.

What's Wrong with the Current System?

Today's "universal service" system is a giant "fuzzball," perpetuated by the LECs, which hides costs, distorts competition and otherwise causes policy concerns. First, the complexity and obscurity of the "hidden" or "implicit subsidies" allow the local telephone companies to use them as a shield against competition. Telephone companies reflexively argue that any additional competition will result in a dire threat to universal service—as, in fact, the Bell System argued in the 1970's when faced with nascent competition in terminal equipment marketing and long distance service. ***It didn't happen then and it needn't happen now.***

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[2] There are also other mechanisms built into the FCC's cost allocation rules that permit small telephone companies to recover a greater share of their costs through long-distance access charges than do the large companies.

[3] Long-distance access charges also recover some of the costs of reducing monthly local service charges for low-income consumers.

Second, because most of the alleged "subsidies" are hidden in long-distance charges and supposedly are reflected in reduced local charges, it is impossible for policymakers to verify how much of an actual subsidy exists or who really benefits from it. The telephone companies' $20 billion estimate is based on LEC cost studies, many of them secret, none of them readily verifiable by regulators, ratepayers or competitors. Some or all of the alleged "subsidy" *could* actually result from prices inflated to compensate for LEC inefficiency or excessive returns to LEC stockholders. ***Subsidies must be made explicit so regulators can monitor them and ensure that they are appropriately assessed and distributed.***

Third, long-distance service is not used solely by the wealthy and local service is not used solely by the needy, so inflating the cost of one to subsidize the other will have undesirable consequences and distort competitive markets. (In fact, certain studies indicate that lower income users have a disproportionately high long distance usage.) In an increasingly mobile society, working Americans shouldn't have to pay inflated rates for long-distance calls to friends and relatives in order to subsidize cheap telephone lines for well-heeled subscribers. ***Subsidies should be targeted to those who need them.***

Fourth, to the extent explicit subsidies do exist today, they are largely targeted to "high-cost" local telephone companies. This gives the recipients a perverse incentive to keep their costs high and rewards inefficiency. Moreover, it leads to an extraordinary situation of low- and middle-income urban users subsidizing wealthier suburban, exurban and rural users. Even prosperous areas like Jackson Hole, Wyoming; Middleburg, Virginia; or Bar Harbor, Maine might qualify for subsidies. ***Subsidies should be targeted to end users, not to telephone companies.***

How Can Universal Telephone Service Be Assured In a Competitive Environment?

Competition in local telephone service need not result in increases in basic local rates, especially for those individuals who are targeted to receive subsidized service—but it does require a new mechanism so that the cost of subsidies (whatever the dollar amount may be) is borne equitably by all market participants. As with other facets of the telecommunications industry, MFS believes that local competition will ultimately lead to an increasing array of differentiated services and lower rates for all Americans.

MFS supports a "play or pay" universal service program, to which all providers of telecommunications service would be required to contribute on a competitively-neutral basis either by providing subsidized services to eligible end-users, by making cash payments into a subsidy fund, or both. ***This proposal is premised on the elimination of entry barriers for all telecommunications services—all services, including basic local dialtone, would be opened to full competition***

Universal service would be maintained in a fully competitive market based on the following principles:[4]

- All existing FCC- and similar State-mandated subsidy programs should be replaced by an independent Universal Service Assurance Fund administered by a neutral third party administrator [perhaps after an appropriate transition period]. (This should not be confused with the existing, and much more limited, "Universal Service Fund" administered by NECA under FCC supervision.)

- The objective of the Universal Service Assurance Fund should be to provide credits to those individual customers who would not otherwise be able to afford basic local telephone service. These customers include the following categories:

    1. Low income users;
    2. Customers in "high cost" (mostly rural) areas; and
    3. Special needs groups (*e.g.*, individuals with disabilities requiring special equipment to obtain access to basic service).

- Subsidies for "high cost" areas should be targeted based on objective criteria such as population density, geography, income statistics and other subscriber characteristics; *not* on actual telephone company costs (thus eliminating any incentive for LECs to inflate costs in order to keep receiving subsidies).

- Eligible customers should receive a credit on their monthly bill to reduce the price of basic service to an affordable level (based on historical local service rates indexed for inflation), regardless of which carrier they obtain service from.

- All telecommunications service providers (such as LECs, CAPs, IXCs, Cellular, PCS) should be assigned a Universal Service Assurance obligation based on consistent and competitively-neutral criteria (such as a percentage of revenues, a fixed amount per access line, or some similar basis). The obligation could be satisfied either by cash payments to the Fund, by extending credits to eligible consumers, or a combination of both.

- The independent Fund administrator should monitor the allowance of credits and the determination of eligibility; determine the industry-wide assessment required to fund the program; settle accounts periodically; collect payments from those service providers who do not satisfy their full obligation through credits to end users; and distribute payments to those carriers who grant credits in excess of their allotted obligation.

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[4] Some aspects of the universal service proposal set forth in this paper are based on MFS' discussions with other industry participants and academic experts, and reflect input from a variety of sources.

To further assure universal service, the incumbent monopoly LECs should continue for the foreseeable future (until alternative services are widely available) to be required to serve all customers within their existing service areas (although they would receive a Universal Service Assurance Fund credit for serving eligible consumers at subsidized rates). Since rates would be allowed to move to cost-based levels (before Universal Service Assurance credits), however, LECs would be fully compensated for serving all customers and there would be an economic incentive for CAPs and other carriers to compete to serve these customers, even in "high-cost" areas, if they can do so more efficiently.